

ARTICLES

The Financial Big Bang and Accounting-Auditing Reforms in Japan

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Abstract

The Japanese financial big bang had a strong influence over the recent efforts to make Japanese accounting more transparent and internationally harmonized. The Business Accounting Deliberation Council has recently issued many pronouncements which are strongly oriented toward the harmonization with international standards of accounting. Despite such efforts, reverse movements against international harmonization are also observed. It means that there are political uses of accounting, including the application of cost method to securities held by banks and the revaluation of land. The Ministry of Finance approved these treatments so that the reported income might be increased. However, these treatments are against the spirit of international harmonization. In the field of auditing, too, departure from the control of bureaucrats is the key notion in order to recover the credibility of CPA audit. Thus it can be indicated that although Japanese accounting and auditing are showing a progress, it is not without the pain.

1. Depression in Stock Market and Asian Monetary Crisis

The Japanese economy is now in a serious recession partly due to a long-term depression in stock market and the sudden monetary crisis in Asian countries. In the financial sector, in particular, bankruptcies among banks, security firms and insurance companies have become a reality, which could never happen before because of the government's policy to protect financial institutions.

On top of that, the bankruptcy of financial institutions resulted in the discovery of illegal practices by high-ranking bureaucrats of the Ministry of Finance (MOF) and the Bank of Japan, who had the strong controlling power over the financial institutions. Thus the Japanese financial policy lost credibility and was thrown into great confusion.

Now that it has become clear that the financial policy led by the bureaucrats resulted in failure, Japan is trying to establish a market-oriented financial policy by means of deregulation. This is referred to as the "Japanese Financial Big Bang", and drastic reforms are taking place in the fields of accounting and auditing as well as in other fields.

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2. Japanese Financial Big Bang

2-1. The Report by the Finance Working Group

The idea of the Japanese financial big bang was originally proposed in October 1996 by the Finance Working Group which was established within an advisory council to the former Prime Minister Ryutaro Hashimoto. The report had the title of “For the Activation of the Japanese Financial System”, and suggested the necessity of making a quick reform of the Japanese financial system by a “big bang” method 1).

As one of the proposals, it urged that the regulation/supervisory system be changed from “one operated under the discretion of the MOF” to “the market-oriented rules”. As examples of the items to be considered, it indicated the disclosure of bad loans and derivative transactions, and the introduction of fair value accounting 2).

2-2. Memorandum of the Prime Minister

On November 11, 1996, Prime Minister Hashimoto sent a memorandum to the Minister of Finance, the Minister of Justice, the Chief of the International Financial Bureau of the MOF and the Chief of Civil Affairs Bureau of the Ministry of Justice 3). This memorandum, which had the title of “Reform of Japanese Finance System — Toward the Resuscitation of Tokyo Market by 2001—” and was often called “Hashimoto Memo”, indicated three principles of the reform. They were (1) Free (the free market operated by market principles), (2) Fair (the transparent and reliable market), and (3) Global (the international and progressive market).

Based on this policy, Prime Minister Hashimoto delivered the general-policy speech at the National Diet on November 29, 1996 4). In this speech, he referred to the abolition/relaxation of regulations, the improvement of disclosure, the review of the accounting system and the review of the legal system. He also promised that the related ministries would firmly cope with the issues together.

The idea of the Japanese financial big bang had a strong influence over the recent efforts to make Japanese accounting more transparent and internationally harmonized. In other words, it was through the influence of the financial big bang that the change of attitude was observed in the MOF which had seemed to have been negative to international harmonization. It should be noted that the idea was not put forward by the bureaucrats, but by the political leadership.

3. Accounting Reform: Toward International Harmonization

Accounting and auditing will play significant roles for the successful accomplishment of

the Japanese financial big bang. Traditionally, Japanese accounting has been strongly based on the “cost-realization” concept, and the Japanese disclosure focused on parent-only financial statements, not on the consolidated financial statements. Such an accounting system is far behind international trends and thus has been regarded as posing a problem of not fully disclosing useful information for investors. These issues have been widely recognized, but the MOF and the Ministry of Justice did not cope with them promptly. These Ministries began to cope with the issues only after the problems became too serious. In this section, a feature of recent activities of the Business Accounting Deliberation Council (BADC) is discussed by simply comparing the number of its most recent pronouncements with those of the previous ten years. The BADC is regarded as the accounting standards setter in Japan.

3-1. Pronouncements of the BADC before Its Organizational Change

The BADC was first established in July 1948. In 1949, it published the first report called “On the Setting of Financial Accounting Standards for Business Enterprises”. The Financial Accounting Standards for Business Enterprises is regarded as the basis of Japanese accounting even today. Since then, many pronouncements have been issued. Exhibit 1 shows eight pronouncements issued by the BADC for the ten years during 1986-1995). This means that, on average, the BADC issued less than one pronouncement per year during this period.

EXHIBIT 1 Pronouncements of the BADC during the Ten Years of 1986 - 1995

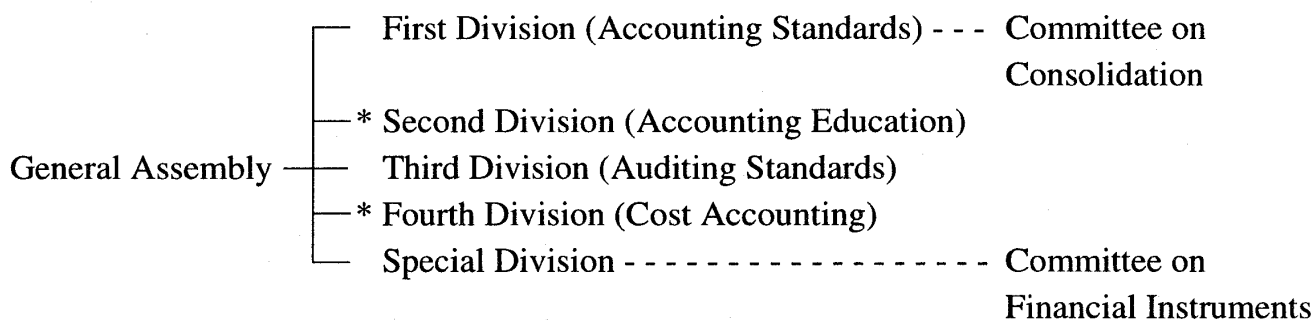
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|------------------|---|
| 1. Oct. 31, 1986 | On the Improvement of Financial Statements in the Disclosure System under the Securities and Exchange Law |
| 2. May 26, 1988 | Opinion on the Disclosure of Segment Information |
| 3. May 11, 1989 | On the Revision of Working Rules of Field Work |
| 4. May 29, 1990 | Opinion on Accounting Standards for Transactions of Futures and Options, etc. |
| 5. May 31, 1991 | On the Revision of Auditing Standards and Working Rules of Reporting (Tentative Report) |
| 6. Dec. 26, 1991 | Opinion on the Revision of Auditing Standards, Working Rules of Field Work and Working Rules of Reporting |
| 7. June 17, 1993 | Opinion on Setting Accounting Standards for Lease Accounting |
| 8. May 26, 1995 | On the Revision of Accounting Standards for Foreign Currency Transactions, etc. |
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3-2. Organizational Change of the BADC

While reviewing the accounting standards for consolidated financial statements, the BADC established a special division in June 1996 in order to carry out deliberation on financial instruments. However, there still remained many topics to be discussed including pensions and R&D. As was indicated above, it was during this period that Prime Minister Hashimoto issued a directive concerning the Japanese financial big bang. Based on his instructions, together with requirements by the Minister of Finance, the MOF decided to change the organizational structure of the BADC at its general assembly in February 1997. Exhibit 2 shows this organizational change (6).

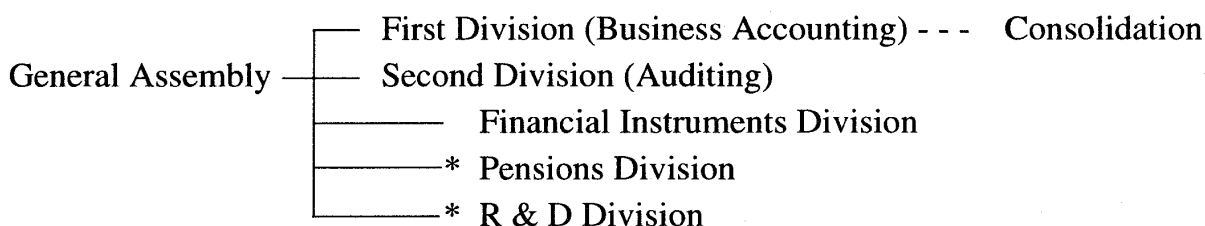
EXHIBIT 2 Organizational Change of the BADC

Old Structure



(Notes) Divisions with * were in substance sleeping divisions.

New Structure (February 1997)



(Notes) Divisions with * have performed their roles, and were abolished in June 1998.

As a result of this change, the BADC now has two permanent divisions. The new First Division (business accounting) was formed by integrating the three old divisions: the First Division (accounting standards), the Second Division (accounting education) and the Fourth Division (cost accounting). The old Third Division (auditing) was transformed to the new

Second Division (auditing). Three special divisions were established in order to deal with (1) financial instruments, (2) pensions and (3) R&D, respectively. Of these, the two special divisions on pensions and R&D have already finished their deliberations and have been closed down. It is expected that more efficient deliberation can be made under this new and flexible organizational structure.

3-3. Pronouncements of the BADC after the Organizational Change

As the result of the organizational change, the BADC started to issue more pronouncements than before. As is seen in Exhibit 3, ten pronouncements were issued by the BADC during the most recent single year (June 1997-June 1998), which exceeds the number of pronouncements issued during the previous ten years.

EXHIBIT 3 Pronouncements of the BADC during One Year after June 1997

1. June 6, 1997	Opinion on the Review of the System of Consolidated Financial Statements
2. June 6, 1997	Issues Paper on the Accounting Standards for Financial Instruments
3. March 3, 1998	Opinion on Setting Preparation Standards for Interim Consolidated Financial Statements, etc.
4. March 3, 1998	Opinion on Setting Preparation Standards for Consolidated Statement of Cash Flows, etc.
5. March 3, 1998	Opinion on Setting Accounting Standards for Research and Development Costs
6. June 16, 1998	Opinion on Setting Accounting Standards for Post Retirement Benefit
7. June 16, 1998	Opinion on Setting Auditing Standards for Interim Reporting
8. June 16, 1998	Opinion on the Revision of Auditing Standards, Working Rules of Field Work and Working Rules of Reporting
9. June 16, 1998	(Exposure Draft) Opinion on Setting Accounting Standards for Financial Instruments
10. June 16, 1998	(Exposure Draft) Opinion on Setting Accounting Standards for Tax Effect Accounting

Although a detailed description about these pronouncements is not provided here, the recent pronouncements are in line with the spirit of the financial big bang. They are strongly oriented toward the harmonization with international standards of accounting. The Japanese Institute of Certified Public Accountants (JICPA) also has been actively involved with the publication of practical guidelines related to these pronouncements.

3-4. Cooperation of the Ministry of Finance and the Ministry of Justice

In June 1998, the Ministries of Finance and Justice published a joint report named "The Report of the Study Group on the Coordination of Commercial Code and Business Accounting". The Study Group was formed in July 1997 and was comprised of scholars of the commercial code and accounting as well as practitioners.

Its formation derived from the issuance of "Opinion on the Review of the System of Consolidated Financial Statements" and "Issues Paper on the Accounting Standards for Financial Instruments". In these reports, the BADC proposed the introduction of fair value accounting and tax effect accounting, which were prohibited by the Commercial Code of Japan.

The above coordination report is the result of discussions by the Study Group on these issues. This report is notable because it is the product of the joint effort by the two Ministries, which had seldom cooperated together. Vertically divided administration is a characteristic of the Japanese central government, which had been an obstacle for accounting reform. Although it seems to be only common sense that both the MOF and the Ministry of Justice should cope with the issues together, they could not realize even such a simple matter under the vertically divided system. They had to wait for the time to come when the Prime Minister issued instructions on the Japanese financial big bang.

4. Political Uses of Accounting against International Harmonization

The recent efforts in Japan toward the international harmonization of accounting standards may be evaluated highly. However, opposition to international harmonization has also been observed. It means there are political uses of accounting that cannot be ignored.

4-1. Applying the Cost Method to Measure Securities Held by Banks

Under the current Financial Accounting Standards for Business Enterprises, either the cost method or the lower-of-cost-or-market method is applicable to the valuation of marketable securities held by business enterprises. Banks and insurance companies had been required to use the lower-of-cost-or-market method. The idea behind this is that unrealized gains should not be recognized as current income, which is supported by the principle of conservatism.

Recently, the measurement of certain financial instruments by fair value has come to be regarded as the internationally accepted method. Taking into account such international trends, the BADC issued an exposure draft of "the Accounting Standards for Financial Instruments" in June 1998. This exposure draft is in line with SFAS No.115 and IAS E62 in that it requires securities other than held-to-maturity securities to be measured at market value 7).

Despite such efforts by the BADC to harmonize accounting standards for financial instruments with international ones, the MOF took the policy to permit banks and insurance companies to use the cost method to measure listed stocks they hold for the fiscal period ending in March 1998 8).

EXHIBIT 4 Estimated Unrealized Gain/Loss on Securities held by Major Banks
(100 million yen)

	Sept.1998	March 1998	Sept.1989
< 9 City Banks >			
Tokyo Mitsubishi *	3,040	9,860	64,200
Tokai	▲1,230	2,500	32,000
Sumitomo	▲2,010	2,550	39,200
Sanwa	▲2,200	2,710	42,000
Asahi	▲2,640	520	31,900
Daiichi Kangyo	▲3,520	1,060	48,500
Daiwa	▲4,000	▲2,070	19,700
Sakura	▲4,900	▲380	57,700
Fuji	▲6,900	▲2,490	43,200
Sub-total	▲24,360	14,260	378,400
< 3 Long-Term Credit Banks >			
Industrial Bank of Japan *	▲410	3,880	55,000
Nippon Credit Bank	▲1,840	▲1,080	22,000
Long-Term Credit Bank of Japan	▲3,840	▲1,710	41,000
Sub-total	▲6,090	1,090	118,000
< 7 Trust & Banking >			
Mitsubishi *	180	2,850	25,200
Nippon	▲130	0	2,800
Toyo	▲770	480	12,500
Chuo	▲1,250	▲600	6,400
Sumitomo	▲1,360	720	22,500
Mitsui	▲1,670	690	26,700
Yasuda	▲2,860	▲1,850	19,700
Sub-total	▲7,860	2,290	115,800
Grand Total	▲38,310	17,640	612,200

(Note) An asterisk (*) means that the bank is applying the lower-of-cost-or-market method for fiscal period ending March 1998.

(Source) *Nihon Keizai Shimbun*, October 1, 1998, April 1, 1998 and November 25, 1989.

Exhibit 4 shows that many of the major banks had unrealized profits of 61 trillion yen during the period of the bubble economy. Now, due to the fall of share prices, the unrealized loss for the same banks are estimated to be 3.8 trillion yen. If no initiative were to be taken under such a circumstance, it was thought that it would be difficult to maintain the Japanese banking system, and that banks would be reluctant to make loans to business enterprises, which in turn would cause business failures. Thus, the MOF permitted banks to use the cost method, which does not require the recognition of unrealized losses.

In fact, Exhibit 4 reveals that most of the banks applied the cost method, and only three banks applied the lower-of-cost-or-market method. These three banks are those banks which did not suffer seriously when share prices fell further afterwards.

By this policy of the MOF, many of the Japanese banks did not need to disclose their unrealized losses. However, the credibility of the Japanese accounting system was badly damaged.

4-2. Revaluation of Land

On March 31, 1998, the National Diet (Congress) enacted the Law on Revaluation of Land. This law aims at contributing to smooth financial operations as well as to improve the health of business management, by stipulating necessary items for the revaluation of land which is held by corporations for business use (Article 1). The law is applicable to business enterprises in general. However, it originally aimed at improving the financial ratios of financial institutions in order to repress the reluctance of banks to make loans. The object of the law is land used for business (not land for sale), and the timing of revaluation is restricted to only one fiscal period between March 31, 1998, and March 30, 2000 (Article 5). The application of the law is at the discretion of the corporation.

As is shown in Exhibit 5, total book value of the land held by the major banks as of March 1997 was about 1,100 billion yen. Estimated market value of the same land was 5,500 billion yen, with the hidden profit (or unrealized gain) of 4,300 billion yen. This large amount of hidden profit is expected to improve the financial condition of the banks once it is recognized in the balance sheet. In the case of the major banks, the ratio of shareholders' equity to total assets might have been improved by 0.96 %, if the revaluation difference was not taxable 9). Naturally, it is expected that the banks will change their attitude to a more positive one in making loans to business enterprises.

Companies other than banks also considered applying the law. For example, Izukyu Railway Corporation, which had been suffering a loss, tried to revalue its land, expecting to improve its shareholders' equity ratio 10). However, the Ministries of Finance and Justice later decided to treat the revaluation difference as liabilities, not as shareholders' equity nor as income 11). Izukyu Railway Corporation then abandoned the policy of applying the law,

simply because it was not useful in improving its financial condition 12). Nonetheless, for banks, the revaluation difference is treated as if it is an item of shareholders' equity, which in turn may be effective in changing the lending attitude of banks.

It was an unbelievable, political decision that the revaluation of land should have been

EXHIBIT 5 Effect of Revaluation of Land in the Major Banks (100 million yen)

	Estimated Market Value	Book Value	Hidden Profit	Ratio of Hidden Profit to Risk Assets
< 9 City Banks >				
Daiichi Kangyo	7,780	757	7,023	1.64
Sakura	6,091	845	5,246	1.28
Tokyo Mitsubishi	6,117	1,305	4,812	0.79
Fuji	6,109	841	5,267	1.30
Sumitomo	5,132	1,027	4,104	0.93
Sanwa	5,318	1,290	4,028	0.98
Asahi	4,829	1,000	3,829	1.74
Tokai	2,768	594	2,174	0.94
Daiwa	2,292	333	1,958	1.60
Sub-total	46,441	7,996	38,445	1.17
< 3 Long-Term Credit Banks >				
Industrial Bank of Japan	2,028	253	1,774	0.56
Long-Term Credit Bank of Japan	926	573	352	0.15
Nippon Credit Bank	857	112	745	0.70
Sub-total	3,811	939	2,872	0.44
< 7 Trust & Banking >				
Mitsui	841	540	300	0.28
Mitsubishi	974	595	379	0.27
Sumitomo	1,104	497	607	0.48
Yasuda	815	441	374	0.48
Nippon	20	16	3	0.03
Toyo	476	204	271	0.40
Chuo	192	134	57	0.17
Sub-total	4,425	2,431	1,993	0.35
Grand Total	54,678	11,367	43,311	0.96

(Source) *Keiri Joho*, No.849 (April 10, 1998), p.24.

For assumptions, see Table 5 of the above material.

approved within the historical-cost framework of Japanese accounting. Of course, it is known in Japan that IAS 16 "Property, Plant and Equipment" allows the revaluation of land using fair value as an allowed alternative treatment 13). But the treatments permitted by IAS 16 are different from those permitted by the Japanese law in many respects, including the object and timing of revaluation as well as the accounting treatment of the revaluation difference.

5. Auditing: Breaking Away from the Control of Bureaucrats

In the field of auditing, a new trend can also be observed. Shareholders, who suffered a loss from the bankruptcy of Yamaichi Securities Co., Ltd. sued the accounting firms which audited Yamaichi 14). Such a situation could not be anticipated in Japan, although it might be common in the United States.

Behind the fact that CPA audit is not regarded as reliable is the inadequacy of the system. There may be many defects to be corrected, but one of the important aspects is the control of CPA firms by the MOF, while another aspect is the non-existence of peer review.

The control of accounting firms by the MOF is said to go back to the mid-1980's, when there were windowdressing scandals in Japan. According to a newspaper report, the MOF required the accounting firms to accept the former government officials as their chairmen with high salaries and low responsibility 15). In turn, the MOF did not further investigate the responsibility of accounting firms for the scandals. This was comfortable to the accounting firms too, in that they could depend on the MOF whenever there were problems. Thus the relationship between the MOF and accounting firms developed.

In order to change this dependent nature of CPAs in Japan, the JICPA recently decided to introduce a system of peer review. It may be a different system from the US system in which an accounting firm reviews the audit done by another accounting firm. In Japan, the Quality Control Committee will be established within the JICPA in order to review the audit by accounting firms. As an outside organization, the Quality Control Board will deliberate on the activities of the Quality Control Committee 16).

Here too, in the field of auditing, departure from the control of bureaucrats is the key concept in order to recover the credibility of CPA audit.

6. Conclusion

As was described in this paper, the financial big bang was proposed in Japan in order to overcome the economic and financial crisis. It was proposed under the political leadership, not by the bureaucrats. It can be considered a positive step that Japan is undertaking accounting reforms with special emphasis on international harmonization.

While a series of efforts were made by the BADC toward international harmonization, the policies were adopted which allowed the companies to apply the cost method to the securities and to carry out revaluation of land by market value. These policies are not compatible with the trends of international harmonization, and means that accounting is mis-used for political purposes. Furthermore, these policies were adopted without consultation with the BADC. This means that it is not clear whether the BADC is actually the standard setter in Japan.

Then, how should we understand these situations from the perspective of international harmonization? According to the findings by Hofstede and Gray, accounting is influenced by national cultures 17). Japanese accounting is thought to be quite different from Anglo-American accounting which is regarded to as the basis of the global accounting. Thus, it is possible that accounting practice under the Japanese culture cannot follow the global standards, even if Japan tries to harmonize its standards with the international ones.

Based on this observation, it may be said that the trials in Japan to pursue international harmonization are now experiencing “the clash of civilizations” suggested by Samuel P. Huntington 18). From an Anglo-American perspective, the change and the progress in Japan may seem to be extremely slow. But from another perspective, Japan is showing a steady progress toward international harmonization and suffering the “pain” caused by the clash of accounting civilizations.

(Notes)

- 1) Finance Working Group, Action Planning Committee, Economy Deliberation Council, “For the Activation of Japanese Financial System,” October 17, 1997.
- 2) *Ibid.*, Chapter 1, 3.
- 3) *Nihon Keizai Shimbun*, November 12, 1996.
- 4) *The Official Gazette (Extra)*, November 29, 1996.
- 5) Prepared based on Toru Kotani, “Organizational Change of the Divisions of the Business Accounting Deliberation Council,” *COFRI Journal*, No.26, March 1997, pp.47-48.
- 6) See “Reform of the Divisions of the Business Accounting Deliberation Council,” *JICPA Journal*, No.501, April 1997, p.87.
- 7) See Financial Accounting Standards Board, Statement of Financial Accounting Standards No.115, *Accounting for Certain Investments in Debt and Equity Securities* (1993). International Accounting Standards Committee, Exposure Draft E62, *Financial Instruments: Recognition and Measurement* (1998).
- 8) *Nihon Keizai Shimbun*, December 24, 1997 (evening edition).
- 9) “Complete Examination of the Revaluation of Land,” *Keiri Joho*, No.849, April 10, 1998, p.24.
- 10) *Nihon Keizai Shimbun*, March 6, 1998.
- 11) *Nihon Keizai Shimbun*, March 19, 1998.
- 12) *Nihon Keizai Shimbun*, May 28, 1998.
- 13) International Accounting Standards Committee, International Accounting Standard No.16, *Property, Plant and Equipment* (1993), par.30.
- 14) *Nihon Keizai Shimbun*, March 28, 1998.
- 15) *Nikkei Kinyu Shimbun*, April 17, 1998.

- 16) *Nihon Keizai Shimbun*, March 12, 1998.
- 17) Geert Hofstede, *Culture's Consequences: International Differences in Work-Related Values*, Beverly-Hills: Sage Publications, 1980. Sidney J.Gray, "Towards a Theory of Cultural Influence on the Development of Accounting Systems Internationally," *ABACUS*, Vol.24, No.1, 1988.
- 18) Samuel P.Huntington, *The Clash of Civilizations and the Remaking of World Order*, New York, N.Y.: Touchstone, 1996.